ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Frommer	Analyst:	Jeff Garnier	Bill Number:	AB 1601
Related Bills:	See Legislative History	Telephone:	845-5322	Amended Date:	April 10, 2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Tax Shelters/Statue of Limitations/Penalties

SUMMARY

This bill would increase the accuracy related penalty (ARP) and the length of time the Franchise Tax Board (FTB) may assess tax deficiencies for investors in abusive tax shelters. This bill would also increase the penalties for promoting and not registering tax shelters.

SUMMARY OF AMENDMENTS

The April 10, 2002, amendments removed all of the bill's provisions, which related to a qualified wage credit, and replaced them with the provisions discussed in this analysis.

PURPOSE OF THE BILL

The author's staff has indicated the intention of the bill is curtail the use of abusive tax shelters.

EFFECTIVE/OPERATIVE DATE

Unless otherwise provided, this bill would be effective and operative for taxable years beginning on or after January 1, 2004.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist with amendments to resolve the technical concerns discussed in this analysis.

Board Position:			Department Director	Date
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ANALYSIS

FEDERAL/STATE LAW

Statute of Limitations

Federal law provides, in general, that taxes be assessed within three years after the date a return is filed (this is the general "statue of limitations" (SOL) for deficiencies). For this purpose, a return that is filed before the original required due date is considered to be filed on the original required due date. If there has been a substantial omission of items of gross income that total more than 25% of the amount of gross income shown on the return, the period during which an assessment must be made is extended to six years. If an assessment is not made within the required time periods, the tax generally cannot be assessed or collected at any future time. Tax may be assessed at any time if the taxpayer files a false or fraudulent return with the intent to evade tax or if the taxpayer does not file a tax return at all.

California law follows federal law with exceptions. California law provides for a four year general SOL. Deficiencies based on federal audit reports can be mailed up to two years after the taxpayer or the Internal Revenue Service (IRS) reports the federal changes to FTB, if the changes are reported within six months of the final federal determination. If a taxpayer or the IRS notifies FTB more than six months after the final federal determination, FTB may mail a deficiency resulting from that adjustment within 4 years of the date the IRS or the taxpayer notified FTB of the change. If the taxpayer fails to notify FTB of the final federal determination, a deficiency reflecting the changes made by the federal determination may be mailed at any time.

Accuracy Related Penalty

An accuracy related penalty (ARP) of 20% applies to any underpayment of tax if the underpayment is due to:

- Negligence or disregard of rules or regulations.
- Any substantial understatement of income tax.
- Any substantial valuation misstatement.
- Any substantial overstatement of pension liabilities.
- Any substantial estate or gift tax valuation understatement.

A substantial understatement exists if the correct income tax liability for a taxable year exceeds that reported by the taxpayer by the greater of 10% of the correct tax or $5,000 ($10,000 in the case of most corporations). For purposes of determining whether a substantial understatement penalty applies, the amount of any understatement can generally be reduced by certain amounts.

For transactions relating to tax shelters the understatement can be reduced for amounts attributable to a tax shelter item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment. A tax shelter is defined, for purposes of determining if a substantial understatement exists, as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of the former is the avoidance or evasion of federal income tax. The Secretary of the Treasury is required to annually publish a list of positions that do not represent substantial authority and affect a significant number of taxpayers.

California law conforms to the federal ARP penalty with minor modifications.

Promotion of Abusive Tax Shelter Penalty

Federal law imposes a penalty on any person who organizes, assists in the organization of, or participates in the sale of any interest in, a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if in connection with such activity the person makes or furnishes a qualified false or fraudulent statement or a gross valuation overstatement.

A qualified false or fraudulent statement is any statement with respect to the allowability of any deduction or credit, the excludability of any income, or the securing of any other tax benefit by reason of holding an interest in the entity or participating in the plan or arrangement which the person knows or has reason to know is false or fraudulent as to any material matter. A "gross valuation overstatement" means any statement as to the value of any property or services if the stated value exceeds 200% of the correct valuation, and the value is directly related to the amount of any allowable income tax deduction or credit.

The amount of the penalty is $1,000 (or, if the person establishes that it is less, 100% of the gross income derived or to be derived by the person from such activity). A penalty attributable to a gross valuation misstatement can be waived on a showing that there was a reasonable basis for the valuation and it was made in good faith.

California law conforms to the federal "abusive tax shelter promoter penalty" with no modifications.

Failure to Register a Tax Shelter Penalty

An organizer of a tax shelter is required to register the shelter not later than the day on which the shelter is first offered for sale. A "tax shelter" means any investment with respect to which the tax shelter ratio for any investor as of the close of any of the first five years ending after the investment is offered for sale may be greater than two to one. The tax shelter ratio is basically the amount of the income tax deductions and 350% of the credits offered by the shelter bears to the taxpayer's investment. Additionally, the shelter must be: (1) required to be registered under federal or state securities laws, (2) sold pursuant to an exemption from registration requiring the filing of a notice with a federal or state securities agency, or (3) a substantial investment (greater than $250,000 and at least five investors).

Other promoted arrangements are treated as tax shelters for purposes of the registration requirement if: (1) a significant purpose of the arrangement is the avoidance or evasion of income tax by a corporate participant; (2) the arrangement is offered under conditions of confidentiality; and (3) the promoter may receive fees in excess of $100,000 in the aggregate.

A transaction has a "significant purpose of avoiding or evading income tax" if the transaction: (1) is the same as or substantially similar to a "listed transaction" or (2) is structured to produce tax benefits that constitute an important part of the intended results of the arrangement and the promoter reasonably expects to present the arrangement to more than one taxpayer.

The penalty for failing to timely register a tax shelter (or for filing false or incomplete information with respect to the tax shelter registration) generally is the greater of 1% of the aggregate amount invested in the shelter or $500. In addition, if the tax shelter involves an arrangement offered to a corporation under conditions of confidentiality, the penalty is the greater of $10,000 or 50% of the fees payable to any promoter with respect to offerings prior to the date of late registration. Intentional disregard of the requirement to register increases the penalty to 75% of the applicable fees.

California law conforms to the federal tax shelter registration requirements with the modification that the tax shelter be organized in California. California law conforms to the federal penalty for failure to timely register a tax shelter with the modification.

THIS BILL

This bill would:

- Extend the SOL from four years to eight years for taxpayers who invest in a "tax shelter." Tax shelter is defined for purposes of extending the SOL only as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if the primary purpose of the former is the avoidance or evasion of federal income tax.
- Increase the ARP from 20% to 50% for taxpayers who invest in an "abusive tax shelter." Abusive tax shelter is defined for purposes of increasing the ARP only as the term "tax shelter" is used under the requirement to register a tax shelter discussed above and has no economic substance.
- Increase the abusive tax shelter promoter penalty from the lesser of $1,000 or 100% of the gross income derived from the shelter to 25% of the total amount invested in the shelter.
- Increase the failure to register a tax shelter penalty from the greater of 1% of the total amount invested in the shelter or $500 to 25% of the amount invested in the shelter.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

The bill defines "tax shelter" and "abusive tax shelter." Both definitions basically define an abusive tax shelter to be the same thing using different terminology. It would be less confusing if the bill only defined the term "abusive tax shelter" using the same terminology.

Additionally, the bill would extend the SOL to eight years for returns filed after January 1, 1999. This provision would generally affect 1998 tax years. The SOL on timely filed 1998 tax returns will expire before this bill becomes effective. The author's staff has indicated the bill will be amended to extend the SOL for returns filed on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 614 (Cedillo, 2003) among other abusive tax shelter curtailment items would create or expand abusive tax shelter penalties for the investor, promoter, tax preparer, and material advisor and extend the SOL to eight years. SB 614 is presently in the Senate Appropriation Committee.

PROGRAM BACKGROUND

An abusive tax shelter involves a transaction or a series of transactions that on the surface appears to meet the letter of the tax law. The transactions themselves have no economic substance and/or are a sham. The economic substance doctrine (ESD) was developed over the years through court decisions, and today is routinely cited as law when examining the validity of tax schemes. In lay terms the ESD states that a transaction, after being stripped of its tax benefits, must have more than a de minimus amount of economic value to the parties. This does not mean that tax benefits must be totally absent from the value of the transaction. However, tax benefits cannot be the principal reason for entering into a transaction.

Most abusive shelters use numerous "step transactions" to arrive at the desired result. Taxpayers use pass-thru entities and spread the step transactions over multiple tax years to complicate the issue and impede identification. Today's shelters have become so sophisticated that it requires a highly trained individual just to identify the shelter, much less the actual examination of the shelter.

OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois, Massachusetts, Michigan, Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws.

Based on a limited review, none of these states have an extended SOL or specific penalties for abusive tax shelters transactions.

The review included the individual state's websites, tax forms, and tax handbooks, all available to the general public.

FISCAL IMPACT

Implementing this bill would not significantly impact the department's programs and operations.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

It is estimated that this proposal would generate $5 million in 2004/05 and annually thereafter. It is estimated that as much as ½ billion dollars in revenue has been lost to the state of California in each of the past four years due to abusive tax shelters. Because of expanded enforcement activity at the federal level, including IRS amnesty programs, use of blanket subpoenas, and revised federal tax shelter regulations, investment in abusive tax shelters is expected to decrease in 2003 and beyond. Since this proposal would be effective for taxable years beginning on or after January 1, 2004, this estimate reflects revenue from projected increased self-compliance resulting from the proposal in the initial years. Any impact generated at the audit level, by an increased statute of limitations period or increased penalties, would be realized in 2007 or after due to the timing of the audit cycle. This estimate is based on federal estimates for similar proposed legislation and departmental information.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

POLICY CONCERNS

Over the last several months numerous well-known corporate and individual taxpayers have come under public scrutiny for investing in potentially abusive tax shelter transactions. The most infamous case is Enron.

To date, the department has identified potential abusive tax shelter cases with a tax revenue loss of $400 million. An additional $400 million in tax is either under IRS control or suspected to be an abusive tax shelter. Total lost revenue over the past four years has been estimated to be on the magnitude of $2 billion. The department is working vigorously to identify the remaining taxpayers understating their tax liability by the unaccounted for $1.2 billion.

It is apparent taxpayers will continue to engage in tax avoidance transactions until the risks to the taxpayer of audit detection and the cost of all back taxes, penalties, and interest due to engaging in the transactions are substantially increased. This bill would increase some of the costs associated with tax shelters, and thus, would discourage some taxpayers from "investing" in such transactions.

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